

Valuation of Intangible Assets in Franchise Companies and Multinational Groups: A Current Issue

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Intangible assets, also referred to as intellectual properties (IP), have become the most valuable assets of the twenty-first century. In the prior centuries hard assets such as factories and equipment were the embodiment of wealth. This article will address several current issues with respect to the identification and valuation of intangibles such as: (1) the obligation of any acquiring company to identify and value such intangibles as it may acquire in the transaction, (2) the annual requirement that such balance sheet goodwill be measured for impairment, (3) the transfer pricing peril and the enormous tax liabilities which can be incurred in licensing IP to affiliates, and (4) the many and confusing valuation methods that are used in such exercises.

Today, many companies own intangible assets worth more than the tangibles. Intangibles often account for more than 80 percent of the total enterprise value. In some cases, the value placed on the intangibles by companies with a long history of acquisitions is greater than the entire net worth of the corporation itself.¹

Interbrand, an appraisal company, valued the Coca-Cola brand or trademark at \$69.6 billion in 2002, and included it in its compilation of "The World's 10 Most Valuable Brands."² For franchise companies the trademarks, franchise operating system, goodwill, and know-how are often the most valuable assets owned.

The issue of valuing intangibles arises, of course, as a damages problem in many types of litigation, but also whenever

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there are mergers, acquisitions, or asset sales. Yet, it is often problematic³ because

[d]espite the fact that intellectual property is frequently bought and sold, [its] valuation . . . generally attracts a degree of skepticism. This arises principally because there is doubt as to whether the value can be measured reliably. This doubt has certainly held back recognition of the value of acquired intellectual property in companies' financial statements, particularly when the property has been acquired along with the business that owns it.⁴

A larger problem is that self-created IP never appears on the balance sheet. Creation costs, including legal fees, search fees, artwork, design, and creative service fees, are expensed, not capitalized, under generally accepted accounting principles (GAAP).⁵

Franchising is usually thought of as occurring directly between unrelated franchisors and franchisees. But international franchising, accomplished by multinational entities (MNEs), generally involves the brand and other intellectual properties first being licensed to subsidiary group entities in various countries and then, at the local country level, licensed by the local member of the MNE to third-party franchisees.

Even in nonfranchise situations, however, the head company of an MNE group generally provides the intellectual property used by the group members. Whether or not there are actual intercompany charges for royalties or license fees, tax authorities of most developed countries require group members to charge each other imputed arm's length license fees with respect to the use of intellectual property. Another type of MNE group funding of IP that is common in the software and certain high technology sectors is cost sharing, which is beyond the scope of this article. Cost sharing is the main alternative to royalty or licensing arrangements in intercompany transactions.

From an accounting point of view, placing a value on hard assets and depreciating the value over time is a well understood financial exercise that has been conducted for centuries. There is no similar universally recognized method of cost recovery for financial purposes with respect to intangibles. Unlike hard assets, intangibles can have an economic presence in many places at the same time.⁶ Today, franchise companies and MNEs are faced with a new set of problems related to the intangible property they create, acquire, own, or license.

One situation requiring valuation of intangibles can arise in the accounting applicable to mergers and acquisitions:

there must be allocations of the purchase price (to the extent that it exceeds balance sheet assets) to intangibles. The intangibles must be defined, assigned useful lives, and appraised.⁷ Subsequently, these purchased intangibles must be measured at least annually for impairment under the rules of the Financial Accounting Standards Board (FASB) Nos. 141 and 142. This exercise involves allocation among the portfolio of marks, patents, copyrights, and other assets disclosed in Items 13 and 14 of the franchisor's disclosure document, and the value of the acquired franchise agreements.⁸

A second valuation area involves cross-border use of IP within an MNE group. This exercise is required as part of the contentious area of intercompany pricing for intangibles. Tax rules in most countries (including the United States, Canada, the United Kingdom, and Australia) require arm's length royalties be charged for the use of intangibles between related companies, e.g., between MNE group branches and subsidiaries which operate in jurisdictions other than the jurisdiction of the franchisor.

The international tax structuring of MNE groups is complex. The franchisor or owner of the intellectual property could be the top or parent company or it could be a special IP holding company which charges royalties to the group members of the MNE located in high tax jurisdictions. When such structures are used, the IP holding company itself will generally reside in a low tax (or no tax) jurisdiction.

Eye-popping numbers can be associated with the intercompany tax issues involved in the MNE group use of IP. In the recently settled GlaxoSmithKline Holdings (GSK) dispute, the taxpayer agreed to pay \$3.4 billion to the IRS rather than take its chances in court.⁹

The issues in the GSK dispute centered on the respective functions performed by the GSK subsidiary resident in the U.S. and by other, non-U.S. members of the corporate group

in creating, developing, and exploiting intellectual property. These issues resonate in sympathetic vibration with the systems and operations of franchise companies and most other MNEs. While one expects to find valuable IP in the technology, pharmaceutical, and consumer product sectors, it is important to note that other MNEs such as those in the financial services sector have very valuable IP coupled with goodwill that is used by group members.

Amounts at Issue

How much are we talking about? How much money is involved? On a simplistic level of financial analysis, practitioners should understand that assets minus liabilities equal shareholder equity on a balance sheet. However, market capitalizations of public franchise companies show that these companies are valued far in excess of the book value shown for shareholder equity. A large portion of this enhanced value consists of the intellectual property and intangibles that do not appear on the balance sheet. For example, Coca-Cola (referenced above), which may be characterized as a product/trade name franchisor, shows balance sheet equity of \$16.92 billion (as of 12/31/06), yet has a market capitalization of \$124.42 billion (as of 9/1/07). This effectively means the market has valued the intangible assets which do not appear on the balance sheet at \$107.5 billion, more than six times the book value of the equity!

On the basis of the same methodology, the IP of some other public companies involved in franchising¹⁰ can be estimated as follows:¹¹

Identification of Intangibles

The first problem associated with valuing intangibles is defining and categorizing them. Companies generally do not take annual inventories of their intangible assets as they do with hard assets. We suggest that this omission must be remedied

	Applebee's APPB	FRANCHISOR Burger King BKC	LARGE CAP McDonalds MCD	Papa Johns PZZA	YUM Brands YUM
Shares Outstanding	74,950,000	134,892,000	1,191,772,000	29,872,000	519,965,000
Earnings Per Share	\$1.04	\$1.11	\$1.33	\$1.65	\$1.56
P/E Ratio	23.91	21.57	37.35	15.39	20.91
Closing Price 8/31/07	\$24.81	\$23.71	\$49.25	\$25.36	\$32.72
Market Capitalization	\$1,859,509,500	\$3,198,289,320	\$58,694,771,000	\$757,553,920	\$17,013,254,800
Balance Sheet Equity 12/31/06	\$448,654,000	\$567,000,000	\$15,458,000,000	\$146,168,000	\$1,437,000,000
Estimated Value of Intangibles - Market cap less equity	\$1,410,855,500	\$2,631,289,320	\$43,236,771,000	\$611,385,920	\$15,576,254,800
Intangibles as % of market cap	75.87%	82.27%	73.66%	80.71%	91.55%

because, in the current climate, a company is advised to set its own parameters with respect to issues like intercompany royalties. This exercise requires the MNE/franchisor to define and separately evaluate whatever intellectual property it owns, licenses to others, or licenses from others.

For public companies this is already a standard exercise to the extent of trademarks and trade names, because these are subject to disclosure in a 10-K or 10-Q. This limited disclosure requirement ignores many other intangible assets however. For example, the mere delivery to a franchisee of a franchisor's operations manual constitutes a transfer of many intangible assets such as goodwill, going concern value, know-how, trade secrets, trade dress, work force in place, unique or registered systems, marketing strategy, marketing training, signage programs, corporate logo(s), websites, corporate colors, labeling design, and copyrights, and public relations value, among others.

In defining and categorizing IP, a franchisor should differentiate between protected intangibles (trade names and trademarks, service marks, brand names, patents, copyrights, etc.) that are registered in some manner and enjoy statutory or well-recognized common law protection and unprotected intangibles (know-how, trade secrets, and most marketing intangibles) that are unregistered and subject to considerable uncertainty in common law protection. The valuation exercise may be different for the protected versus unprotected IP assets.

In some cases, there is a requirement to classify the intangibles into trade intangibles and marketing intangibles.¹² For valuation purposes the consideration devoted to create intangibles is generally an important factor. But not all expenditures produce a valuable trade intangible, and not all marketing activities result in the creation of a marketing intangible. Thus, while an analysis of the expenses associated with the creation of IP is necessary as part of the calculation

to determine the value of the resulting IP, a cost analysis alone is not sufficient.

However, rather than differentiating or separately classifying their intangible assets, companies tend to lump them together under the rubric goodwill. As noted above, self-created intangibles such as franchise rights or customer lists do not appear on the company's balance sheet at all, while acquired intangibles are generally accounted for with language such as the following: "Goodwill represents the excess of the cost of businesses acquired over the fair value of the net identifiable tangible and intangible assets."¹³

A Multitude of Valuation Methods

Once an enterprise has identified and categorized the intangibles, it is faced with a multitude of difficult and confusing valuation methods. Based on the theory that intangible assets generate premium returns for businesses that own them, most of these valuation methods attempt to focus on an increase in revenues or decrease in costs that can be directly attributed to the intangible.

The three basic methods for determining the fair market value of any property are the capitalization of earnings, book value, and comparable sales methods.¹⁴ The intangible properties most frequently at issue in franchise companies are the trademarks and goodwill. There are several generally accepted subsidiary methods for valuing trademarks. These are: the profit split method, the selling price differential method, the econometric method, and the relief from royalty method.¹⁵

Unfortunately, many elements of these methods are based on the fiction that data is available for comparable companies in comparable situations. Alternatively, the calculation mechanics mandated by a given method may have no connection to how business is conducted in the real world. Thus, these methodologies are often of little value.¹⁶

	Buffalo Wild Wings BWLD	FRANCHISOR CKE restaurants CKR	SMALL CAP Max & Erma's MAXE	Rocky Mountain RMCF
Shares Outstanding	17,596,000	57,262,000	2,554,000	6,376,000
Earnings Per Share	\$1.11	\$0.72	\$0.02	\$0.74
P/E Ratio	31.42	23.53	375	21.67
Closing Price 8/31/07	\$34.77	\$16.95	\$7.27	\$16.01
Market Capitalization	\$611,812,920	\$970,590,900	\$18,567,580	\$102,079,760
Balance Sheet Equity 12/31/06	\$116,216,000	\$378,846	\$13,034,000	\$14,515,000
Estimated Value of Intangibles - Market cap less equity	\$495,596,920	\$970,212,054	\$5,533,580	\$87,564,760
Intangibles as % of market cap	81.00%	99.96%	29.80%	85.78%

This is an area of mindnumbing complexity because there are also many other valuation methods which are corollaries or modifications of the methods listed above and all of which are really variations of the capitalization of earnings or income method. Put simply, the methods attempt to estimate the future anticipated stream of earnings and cash flow (the income generated by the intellectual property), and discount such revenues to create net present value. Basically, all are variations of the Discounted Cash Flow (DCF) method.¹⁷

Some of the other currently acceptable valuation methods of which practitioners should be aware are the Excess Operating Profits or Premium Profits Method, the Premium Pricing Method, the Cost Savings Method, the Royalty Savings Method, the Market Approach, and the Cost Approach. The chart below¹⁸ shows which of these methods (with overlap) are used to value various types of IP.

To make matters more devilish yet, the IRS has another list of methodologies: the comparable uncontrolled transaction method¹⁹; the comparable profits method²⁰; the profit split method and its subsets, namely, the comparable profit split method and the residual profit split method.²¹ These all presume comparable data to be available, and therefore—as discussed above—are difficult if not impossible to apply reliably because comparable data from comparable companies is rarely, if ever, available. Unfortunately, this deprivation of comparable information applies to MNE corporations (i.e., the taxpayers), but not necessarily to the tax authorities (as discussed below).

Accounting for IP in Mergers and Acquisitions

As noted above, self-created intangibles do not appear on a company's balance sheet. In the event of an acquisition, however, whether by a multiunit franchisee, a multisystem franchisor or any other acquirer, IP must be enumerated to quantify the extent to which the purchase price of the acquired companies exceeds the replacement value of the acquired book assets (i.e., the goodwill allocation). Practitioners should be aware that FASB 141 requires valuation of acquired intangibles in all business combinations (merger, purchase, consolidation, etc.) and with respect to the acquisition of groups of assets (asset acquisition).²² The stated purpose of FASB 141 is to make financial reporting better reflect investments made in acquired entities, improve the comparability of reported information, and provide more complete information.

FASB 141 requires using the purchase method of accounting to evaluate all business combinations which result in the above-referenced purchase price allocation to intangibles and goodwill. Parties are required to estimate the fair value of acquired intangibles in accordance with methods specified in the Rule which requires valuation of all acquired intangibles. These must be categorized in two groups: those with identifiable useful lives (which are to be amortized over such useful lives) and those with indefinite useful lives, all of which are categorized as goodwill. Acquired franchise agreements with royalty history or some other predictive cash flow are usually valued to the end of their current terms, although systems with high renewal rates may look to a longer time frame for the useful lives of such franchise agreements.²³

Prior to the implementation of FASB 141 and FASB 142, the GAAP rules generally required amortization of acquired intangibles over a term of up to 40 years. Since 2001, however, FASB 142 requires that companies test such goodwill at least once a year for impairment rather than automatically take a charge. If there is impairment, it must be accounted for as a writedown of the asset and a charge against income,²⁴ but if there is no impairment, no action is taken. No increase in the book value of IP is allowed for financial reporting purposes.

FASB 142 provides specific guidance on the required yearly exercise:

Goodwill will be tested for impairment at least annually using a two-step process that begins with an estimation of the fair value of a reporting unit [e.g., the business unit that was acquired]. The first step is a screen for potential impairment, and the second step measures the amount of impairment, if any.²⁵

However, if certain criteria are met, the requirement can be satisfied without a remeasurement of the fair value of the reporting unit and, if there is no impairment in the value of the reporting unit, there is no need to measure the value of the intangibles for impairment.

A recent example of this exercise involving a public company was the goodwill writedown of the brand Clarica by the acquirer of the Clarica insurance group, Sun Life Financial, a large Canadian-based MNE in the insurance and financial services sector. The acquisition was made in 2002. Then, in the second quarter of 2007, more than \$60 million of goodwill was written off because the company decided to retire

Common Methods for Valuing Certain Intangible Assets					
Asset	Valuation	Method			
	Excess Operating Profits	Cost Savings	Royalty Savings	Market Approach	Cost Approach
Brands	X		X	X	
Customer Lists				X	X
Patents	X	X	X		X
Know-How	X	X	X	X	X
Franchises				X	X

the Clarica name and rebrand their business under the Sun Life name. A rebranding expense of about the same amount was announced by the company. The spending on the rebranding exercise will create an internal intangible, and thus there will be no balance sheet recognition.

Intercompany Pricing Issues for Multinationals and Franchisors

Another area requiring valuation of intangibles for franchise companies and other MNEs is intercompany pricing in international operations. It must be understood that intercompany pricing has always been looked upon with a jaundiced eye.²⁶ But as challenging as transfer pricing issues are in general, they reach a new level of complexity when intangibles are involved. Under IRC § 482,²⁷ the IRS has broad authority to adjust and reallocate the income and expenses of MNEs for marketing activities, and in connection with patents, trademarks, and other intangibles. The final sentence of § 482, added in 1986, provides that “[i]n the case of any transfer (or license) of intangible property . . . , the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.”²⁸

As noted earlier, a recent settlement between the IRS and U.K.-based MNE GSK, a huge pharmaceutical group, garnered significant press. The IRS, exercising its powers under § 482, increased the income of GSK’s U.S. entity by many billions. The settlement for the tax on the reallocated income plus interest was \$3.4 billion, with the IRS announcing:

The Tax Court dispute for years 1989–2000 involves intercompany transactions between GSK and certain of its foreign affiliates relating to various GSK ‘heritage’ pharmaceutical products. Specifically at issue is the level of U.S. profits reported by GSK after making intercompany payments that took into account product intangibles developed by and trademarks owned by its U.K. parent, and other activities outside the U.S., and the value of GSK’s marketing and other contributions in the U.S. Under the settlement agreement, GSK has conceded over 50 percent of the total amount put in issue by the two parties for the years pending in Tax Court.²⁹

The \$3.4 billion was the largest single payment ever made to the IRS to resolve a tax dispute, and it only resolved GSK’s transfer pricing problems through 2005.³⁰ As a wake-up call to similarly situated taxpayers (such as franchisors), Mark W. Everson, Commissioner of Internal Revenue, stated at the time, “We have consistently said that transfer pricing is one of the most significant challenges for us in the area of corporate tax administration. The settlement of this case is an important development and sends a strong message of our resolve to continue to deal with this issue going forward.”³¹

The resolve of the IRS is to be noted along with the size of the income adjustments. Another multibillion dollar IP-related adjustment for a software company is now before the U.S. Tax Court.³² There have been significant IP/royalty-related tax

assessments in other countries. For example, the Canadian tax authorities have pursued the issue (and are proceeding to court) with several MNEs and recently reached a significant settlement with the GSK Canadian group on issues similar to those pursued by the IRS.³³

The tortured history of IRC § 482 and its corresponding regulations (a complete discussion of which is beyond the scope of this article) is worth noting. Under earlier tax law, § 482 allocated the entire return from an intangible to the legal owner of the intangible.³⁴ This was an all-or-nothing allocation.³⁵ The regulations in turn required that one of four specified methods be used to determine an arm’s length license or royalty amount that the owner of the IP must charge other group members.³⁶ However, it was not difficult to avoid reallocations of income under these rules and this was the impetus for many U.S.-based MNEs to migrate existing intangibles and to have new intangibles owned by subsidiaries resident in tax-haven or low-tax jurisdictions.

As a result, the new § 482 regulations are an about-face and recognize that intangibles can have many owners under the new test of economic ownership. The economic ownership test has been the standard in other Organization for Economic Cooperation & Development (OECD) countries, including Canada, for many years. This theory, ironically relied on by the IRS in GSK even before the change in the regulations, generally results in income from intangibles being reallocated to the United States rather than accruing to the legal owner of the IP in a low-tax jurisdiction.

The current regulations under § 482, adopted July 31, 2006, and corrected December 19, 2006, came into effect on January 1, 2007. To prove the matter is still in flux, the regulations are called temporary regulations, even though proposed regulations were issued in September 2003 and congressional hearings were held in January 2004.

The view of the Canadian tax authority, Canada Revenue Agency (CRA), has been more consistent with OECD views, and has not changed significantly in the last two decades. The position expressed by CRA foreshadowed the revised position the IRS adopted with respect to GSK. The Information Circular released by CRA in 1987 clearly set out its economic view:

The very nature of intangible property may often make its valuation difficult. The inherent risk often associated with intangible property may produce significant fluctuations in their value. In addition, intangible property may be of significant value even though it has no or little book value in the taxpayer’s balance sheet.³⁷

Further,

[t]axpayers who do not own trademarks or trade names sometimes undertake marketing activities. In these instances, the issue arises as to whether they should share in any return attributable to the marketing intangibles. Distributors who bear the costs of marketing activities would usually expect to

share in the return from the marketing intangibles. As well, distributors who bear marketing costs in excess of those that an arm's length distributor with similar rights to exploit the intangible would incur, would expect an additional return from the owner of the trademark or trade name. The actual marketing activities of the distributor over a number of years should be given significant weight in evaluating the return attributable to marketing activities.³⁸

The value of an intangible (however determined) is a major factor in determining the appropriate arm's length royalty for the use of that IP. This royalty in turn determines the range of income, if adequate royalties are not charged, that could be imputed to the licensor creating additional taxable income. In the event of such reallocation, generally, there will have been no tax deduction by the licensee, located in another country, to offset the imputed revenue to the licensor. Many countries prohibit MNE members from refileing the licensee tax returns for earlier years to reflect the increased license expense. In tax parlance, this means the MNE can end up in a "double tax" situation, leaving the taxpayer to litigate or resort to the inefficient and expensive process of tax treaty arbitration.

The tax treaty procedure requires the involved MNE members to supply extensive information. Then the competent authority (representatives of the tax authorities of the two or more countries) attempts to resolve the double tax issue. Taxpayers are subjected to a multiyear process that may yield only partial results and will almost certainly involve significant net tax and interest costs.³⁹ The inadequacies of the competent authority procedures due to the failure of the IRS and the CRA to agree to a position that relieves double taxation may be improved through a mandatory arbitration procedure, which was announced in the September 21, 2007, Protocol to the Canada-United States Tax Treaty. It will be a number of years before a judgment can be made as to whether this second level of arbitration is effective in avoiding double tax.

Earlier in this article we noted that comparables or third-party licensing values are rarely available to taxpayers that are attempting to value IP and establish arm's length royalty and licensing rates. Unfortunately for the taxpayer, this is not reciprocally true for the tax authorities. MNEs in the United States, Canada, and some other jurisdictions must file, as part of the annual tax return process, detailed schedules outlining the group transfer pricing practices, and providing details on what royalties MNEs are or are not charging for IP within the group. The tax authorities can compare the charges made within one MNE to those made within a different MNE. In addition, this information can be exchanged among the tax authorities of different countries under the

provisions of the international tax treaty network. Thus, the information base available to the tax authorities is a powerful tool in the cross-border IP valuation area. Taxpayers may only access the information the tax authorities have derived from other MNEs as comparables during the litigation process, but even then with considerable difficulty.

Conclusion

We strongly suggest that franchise companies and all other MNEs with substantial value invested in their brand or other IP conduct an inventory or legal audit of their protected and unprotected intangible assets. For parties involved in the M&A sector, the current value of acquired IP must be known to determine whether or not it has been impaired.

The valuation/transfer pricing exercise is also essential to justify the outgoing royalty paid by an MNE member. Failure to support the royalties paid by the United States subsidiary was a key element in the multibillion-dollar GSK settlement. In that case the U.K. parent had already paid tax in the United Kingdom on royalties for which the deduction was disallowed to the U.S. subsidiary for tax purposes. Disputes over issues

and adjustments in this area are factually intensive and difficult to resolve.

To avoid problems in all areas where valuation of intangibles is important, including possible litigation damages, franchise companies and all other MNEs involved in international transactions with substantial value invested in their

brand or other IP would be well advised to set their own parameters; prepare their own schedule of intangibles; and ascribe to each a supportable value, a useful life, and an appropriate arm's length return. This exercise will allow an arm's length royalty or license to be implemented before any tax, financial, or regulatory authority imposes such values upon them. Equally, there must be valuations and support for the royalties and license fees paid by MNE members to ensure the fees are deductible for tax purposes.⁴⁰ Studies done before a dispute arises carry far more weight than those prepared in contemplation of litigation.

Endnotes

1. See, e.g., financial statements attached to Forms 10-K for Tyco International and Cendant in 2001 and 2002.
2. Bus. Wk., Aug. 2002. At the time the stock was in the low 40s. At the time of this writing, in Sept. 2007, it is in the mid-50s.
3. According to research done by Prof. Jenny Buchan of the University of New South Wales for a forthcoming article that she shared with the authors, intellectual property is also an underutilized source of equity against which the franchisor could borrow. She searched all registered intellectual property interests (trademarks, registered designs, and registered patents) of 337 franchisors in Australia that

Taxpayers are subjected to a multiyear process that may yield only partial results and will almost certainly involve significant net tax and interest costs.

had retail franchisees in New South Wales and found that only 4 (1.19 percent) had any security interests registered against their trademarks.

4. Caroline Woodward, *Valuation of Intellectual Property*, Price-waterhouseCoopers (London 2006), at 2.

5. See, e.g., Internal Revenue Code (IRC) § 1060 and comparable mandates under the guidelines issued by the Organization for Economic Cooperation & Development (OECD). As pointed out to the authors by Professor Buchan, *supra* note 3, the rule is the same in Australia where AASB 138 is the applicable standard. As in the United States, intangible assets may be recognized only upon acquisition from an external party and only where there is an associated cost. Internally generated intangibles cannot subsequently be recognized through revaluation.

6. Cf. IRC § 197, which for tax purposes mandates straight line amortization of 197 intangibles, such as franchise rights over fifteen years.

7. A similar methodology applies under IRC § 1060, the legislative history of which showed that the committee believed that it is appropriate to treat the premium involved in acquisitions as a payment for assets in the nature of goodwill or going concern value rather than some other form of excess payment. See Bruce S. Schaeffer, *Tax Aspects of Franchising* (BNA 559-2d T.M. Portfolio 2005), at A 16-17.

8. The authors are particularly grateful to Joel Buckberg of Baker, Donelson, Bearman, Caldwell & Berkowitz, P.C., for this insight.

9. Internal Revenue Serv., News Release 2006-142, Sept. 11, 2006.

10. The companies and the designations as franchisor large cap or franchisor small cap in the table are taken from the regularly published listings in *Franchise Times* magazine.

11. Source: AOL Financial as of 9/1/07. This is admittedly a very simple and rough methodology based on easily available public information that tends to yield high IP values. It would have to be adjusted for many items like accumulated depreciation (and asset appreciation) to get a more precise determination.

12. See, e.g., the Organization for Economic Cooperation & Development (OECD) guidelines which have been adopted by most major economic powers but not by the United States.

13. See, e.g., Sun Life Financial, Inc. Annual Report (2006), at 6.

14. These are the definitions of *fair market value*, a legal term. In accounting, the term is *fair value* and the methods are denominated income (capitalization of earnings), cost (book value), and market (comparable sales), respectively.

15. See BYRON E. FOX & BRUCE S. SCHAEFFER, *FRANCHISE REGULATION AND DAMAGES* § 20.02 (CCH 2005).

These methods are defined as follows:

Profit split method: This is based on the division of after-tax operating margin that a licensee would be willing to pay, after taxes, to a hypothetical licensor for the use of a trademark or trade name.

Selling-price-differential method: This calculates the value of trademarks and trade names by determining the incremental price differential attributable to trademarks and trade names over unbranded products or services and then splits the premium portion of the price between the hypothetical licensor and the hypothetical licensee.

Econometric method: This method purports to derive implied economic values for trademarks expressed as a percentage of sales. Several cases have recognized the validity of somewhat similar regression analyses.

Relief-from-royalty method: This method relies on an analysis of third party license agreements to determine an appropriate royalty rate. Once such comparable royalty is determined, three steps follow:

(1) determining the projected excess earnings for the branded product or service, (2) selecting an appropriate royalty rate for the license, and (3) computing the present value of the royalty payments using a discounted cash flow method.

16. For extensive background on this issue, see the excellent article by Alan Winston Granwell & James E. Brown, *Coming Conflicts: Proposed U.S. Transfer Pricing Services Regulations and the Treatment of Intangibles* (PLI 2006).

17. A full explanation of the DCF method is beyond the scope of this article, but it can be simplistically described as following three steps: (1) an estimation of net cash flows that the firm will generate over a projected period; (2) computation of a terminal or residual value equal to the future value of the firm's cash flows beyond the projection period; and (3) the application of a discount rate (estimated cost of capital) to reduce to present value the projected net cash flows and the estimated terminal or residual value.

18. Adapted from Woodward, *supra* note 4.

19. Reg. §1.482-4(c).

20. Reg. §1.482-5.

21. Reg. §1.482-6.

22. FASB 141 and FASB 142 were promulgated in 2001 (effective for fiscal years beginning after December 15, 2001) to address the issues of valuing intangibles in financial reporting.

23. The authors are grateful to Joel Buckberg of Baker, Donelson, Bearman, Caldwell & Berkowitz, P.C. for also bringing this point to their attention.

24. Under the rules of FASB 142, intangibles' values are now to be measured under the rules of FASB 121 and 142.

25. Summary of Statement 142—Goodwill and Other Intangible Assets (Issued 6/01).

26. BUTTERWORTH'S BUSINESS AND LAW DICTIONARY 447 (Sydney 1997) calls it a tax minimization technique involving the manipulation of the price of goods or services such that the profits are transferred between entities.

27. IRC § 482: Allocation of Income and Deductions Among Taxpayers. In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

28. *Id.* As defined in § 936(h)(3)(B), which includes: "(iii) trademark, trade name, or brand name; and (iv) franchise, license, or contract."

29. See IRS news release, *supra* note 9.

30. *Id.*

31. *Id.* "This settlement exemplifies the IRS's continuing commitment to resolve transfer pricing disputes through responsible and
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innovative agreements that embody the arm's length standard for related-party transactions—or through litigation when necessary Transfer pricing that allocates an appropriate return to the U.S. affiliates of multinational groups is a key focus for the IRS," said IRS Chief Counsel Donald Korb. "We are pleased that GSK has chosen to put this controversy behind it. Our decision to accept GSK's settlement offer reflects our commitment to resolving transfer pricing controversies without litigation, provided that our ultimate goal of compliance is not compromised."

32. VERITAS Software Corp., a subsidiary of Symantec Corp., filed a U.S. Tax Court petition protesting a total of \$757.6 million in deficiencies resulting from \$2.5 billion in transfer pricing allocations relating to buy-in payments, stock options, and other cost sharing issues with foreign affiliates for 2000–01 (VERITAS Software Corp. v. Commissioner, T.C., No. 12075–06, petition filed 6/26/06). In GSK, the IRS, exercising its powers under § 482, had increased the income of GSK's US entity by \$4.5 billion for cost of goods sold, \$1.9 billion for royalties and \$1.4 billion for interest income on the imputed transactions. In VERITAS' filing with the Tax Court, the company said the Internal Revenue Service erred when it:

- allocated \$2.4 billion to VERITAS for buy-in payments the IRS said it should have made to Irish affiliate VERITAS Software International Ltd.;

- allocated \$9.9 million between VERITAS and Irish affiliate VERITAS Software Holdings Ltd. to include stock-based compensation in the research and development cost sharing pool;
- allocated \$9.9 million between VERITAS and allocated \$65.8 million to VERITAS from VERITAS Software Holdings Ltd. for other unspecified costs in their cost-sharing agreement; and
- allocated \$9.9 million between VERITAS and allocated \$25.4 million to VERITAS from company's foreign subsidiaries, in aggregate, for services performed in 2001.

33. Canadian Transfer Pricing Litigation: Settled or Heard: *Glaxo-SmithKline* (settled); *BMO Nesbitt Burns* (settled); and *Glaxo Wellcome Inc.* (heard in summer 2006). IFA International Tax Seminar, May 17–18, 2007, Joint Seminar of the Canadian and United States Branches. Transfer Pricing Developments.

34. Reg. § 1.482–4(f)(3).

35. Reg. § 1.482–4(f)(3)(ii)(A).

36. Reg. § 1.482–4(a)(1)–(4). The methods were the comparable uncontrolled transactions method, the comparable profits method, the profit split method, and certain other unspecified methods.

37. IC 87-R2, CRA Information Circular ¶ 141.

38. *Id.* ¶ 148.

39. *Id.* ¶¶ 218, 219.

40. *See, e.g.*, Dutch and Belgian cases cited in Isabel Verlinden and Patrick Boone, *Reporting Intellectual Property*, PricewaterhouseCoopers (Brussels 2005), at 4 ("This case illustrates that economic analysis and documentation of it can be vital in defending prices or reported asset values. The existence of a valuation report and a marketing report were key to winning the case.").